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C O N F I D E N T I A L SECTION 01 OF 05 SHANGHAI 007096

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STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SF FRB
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USDOC FOR ITA A/DAS MELCHER, MCQUEEN
NSC FOR HUBBARD AND TONG

E.O. 12958: DECL: 11/30/2031
TAGS: EFIN ECON PREL CH
SUBJECT: CHINA FOREX: AFTER NEW HIGHS, NEXT STEPS NEEDED

REF: A. SHANGHAI 7091

¶B. SHANGHAI 5846
¶C. SHANGHAI 1356
¶D. SHANGHAI 1355

CLASSIFIED BY: Mary Tarnowka, Political/Economic Chief, U.S.
Consulate Shanghai, State Department.
REASON: 1.4 (b), (d)

¶1. (SBU) Summary: As the RMB continued to set record highs, closing at RMB 7.84 per USD on November 27, Shanghai forex traders expressed appreciation for the greater volatility in the forex market and predicted continued gradual appreciation of the RMB. In a series of meetings in late October and November, representatives of foreign banks trading foreign exchange in Shanghai discussed market trends and identified future necessary reforms as including: allowing banks to hold net open positions shorting the dollar; expanding the 0.3 percent intra-day trading band; reducing the paperwork required for forex trading; and liberalizing interest rates to develop more effective market pricing of forex derivative products. In a November 28 AmCham Shanghai address, Standard Chartered Senior Economist Stephen Green shared his analysis of China's foreign exchange policy. End summary.

¶2. (SBU) In late October and November, P/E Chief and Econoff met with representatives from five banks engaged in forex trading in Shanghai to discuss recent trends and identify necessary reforms. Those interviewed included: Citigroup Head of Sales and Trading Paulus Mok, Citigroup Global (Citi) Capital Market Vice President Alan Chan, and Citigroup Chief FX Dealer You Jiong; JP Morgan Treasurer and Head of Marketing and Trading Andrew Zhang; HSBC Deputy Treasurer Ryan Song, Bank of Montreal (BMO) Managing Director and Head of Asia Robert T. Martin and (via telephone) Guangzhou-based currency trader David Mu; and Standard Chartered (SC) Senior Economist Stephen Green.

CITIGROUP: THE MARKET IS RATIONAL

¶3. (C) According to Citigroup's (Citi) Mok, Secretary Paulson's visit to China was "well-received" in a market that had been increasingly volatile. He noted that at the beginning of 2006, daily volume of RMB traded was approximately $500 million. By the end of October 2006, however, volume was $40-50 billion per day. He claimed that Citi ranked among the top of foreign banks trading RMB. Mok said that the market was acting "more rationally," but that it was clear that the Bank of China (BOC) had the overriding influence in setting the morning reference price. Mok believed that in terms of overall trade volume, Citi usually ranked second or third behind the BOC, vying with HSBC. When pressed, Mok said that Citi "sometimes sees that it has some influence" on the morning reference price quoted by CFETS at 9:15 AM on every trading day, based on a (secret) weighted average of market maker bids. That being said, Mok added, it would be impossible to know for sure.

¶4. (C) Mok said that of the 15 Market Makers, he surmised that BOC represented 15-20 percent of the total volume traded on the CFETS system. Citi handled between 5-10 percent (sometimes up to 15 percent) of daily volume. Mok added that the six foreign Market Makers accounted for roughly 30 percent of all trade with the nine Chinese banks accounting for most of the rest. Foreign banks also had demonstrated a higher tolerance for risk than the Chinese Market Makers.

¶5. (SBU) Mok said that the market volume had been increasing due to two factors. He pointed out that (1) there had been an increase in the numbers of trades made close to the end of the trading day (5:30 PM) as traders were increasingly willing to stake out a position. He noted that the extension of trading hours on the matching system was helpful in that regard because it provided a market of last resort for traders needing to clear their positions. Mok added that (2) Chinese traders were

getting more experienced and more confident trading.

¶6. (C) Mok said he expected the PBOC to maintain its long-term control over the value of the RMB, but to allow greater intra-day and inter-day volatility. His perception was that the Chinese authorities and regulators were pleased with the increased volatility as it gave their banks and corporations a chance to learn how to react to currency fluctuations.

¶7. (C) According to Mok's contacts at the PBOC, the increasingly large foreign currency reserves were beginning to be seen as a "big burden." Mok, and Citi's head trader You both commented that PBOC's involvement in forex trading was noticeable behind-the-scenes, from the time that the rate was set every morning to the close of trading. Mok stated that PBOC sterilized its purchases two times a week. Mok surmised that for some "big deals, like when Sinopec needs $1 billion in cash," it appeared PBOC worked directly with BoC without going through the CFETS platform. However, he believed all sales of U.S. dollars went through CFETS in order to maintain the value of the RMB.

¶8. (SBU) According to Mok, Citi's wish list of forex reforms was: (1) Change the exposure limit calculation to two-way (allowing traders to both long and short the dollar; currently traders are only allowed to hold net open positions longing the dollar); (2) Raise or eliminate the "arbitrarily-set" short- and long-term foreign debt limits that restrict Citi's ability to function efficiently as an international bank; (3) Allow corporations to "net settle" the end result of multiple daily trades (as banks are now); (4) Standardize and reduce the amounts of documentation needed for contracts to allow the ability to do cash flow and budget hedging; and (5) Increase the intra-day trading band beyond 0.3 percent of the daily reference price.

HSBC: NO NEED TO WIDEN THE BAND

¶9. (C) According to HSBC's Ryan Song, China's forex market was "stable and liquid." HSBC had two to three forex traders in China, compared to the more than 20 forex traders at BOC. Song said that HSBC perhaps had "some small impact on the value of the reference price at 9:15 AM," adding that HSBC's influence on setting the price appeared to be in line with what his traders understood to be their weighting and size within the CFETS system.

¶10. (C) Song also noted the increased market volatility by pointing out that while a normal trading day might see the market move between 100 and 200 pips away from that morning's reference price, it had not been unusual to see 100 pip swings in price "in a few minutes." In response to a question about the affect of the Chinese government purchasing large quantities of dollars, Song said that he and his traders could tell when huge trades took place since the market sometimes moved dramatically "from the time when they decided to make a trade and the two seconds it took for them to manually enter that trade." Their only explanation for these changes was that PBOC had been making a large dollar purchase. Song noted that his traders often squared USD 10-20 million without moving the market and so speculated that the rapid "drying up of liquidity" was related to massive purchases of dollars.

¶11. (C) The forex reform that HSBC would most like to see implemented, according to Song, was the ability to short the dollar. In contrast to Citi, however, Song indicated that there was no need to adjust the 0.3 percent trading band (equivalent he said to about 2,000 pips) since at its most volatile, the trading swings had only been 100-200 pips.

¶12. (C) Song told P/E Chief and Econoff that HSBC had been attempting to educate Chinese policy makers and regulators on the importance of continued reforms of the forex market. He said that HSBC sent representatives to Beijing to educate them

on the benefits of having a more volatile market-based foreign exchange market. HSBC also informed Beijing that the next step should be to allow forex options since banks were ready in terms of the technical infrastructure and system. Song also said that HSBC had argued for the creation of a strong inter-bank borrowing curve -- the vital next step in permitting banks to accurately price the forwards market.

BANK OF MONTREAL: PUNCHING ABOVE ITS WEIGHT

¶13. (C) Econoff's meeting on October 25 with BMO's head Robert Martin was, according to Martin, the first contact he had had with the USG since coming to China four years previously. He added that his headquarters had initially viewed the meeting request with suspicion, convinced that the underlying goal of the meeting was to figure out its market-share in order to help a U.S.-bank replace BMO as a CFETS Market Maker. Martin told econoff that he had persuaded his headquarters to permit the meeting by reminding them that BMO owned Chicago-based Harris Bank and so ought to be considered a "U.S.-institution as well."

¶14. (C) Martin said that part of his institution's defensiveness was based on its own understanding that its position as one of six foreign Market Makers in China's forex system was a bit of an anomaly given its relative size compared to banks like Citi and HSBC. Martin was very proud of the fact that BMO "punched above its weight" in China. Martin informed Econoff that BMO moved into China in the mid-1990s, at a time when few other banks were interested in China's forex market, in anticipation of the day when China's forex market would liberalize. It established good relations with SAFE and other regulatory bodies and helped to educate Chinese policy and regulation makers on forex markets. This investment paid off, according to Martin, with BMO becoming one of the Market Makers. However, this

status was now threatened by other foreign banks attempting to replace BMO. He said that BMO believed that it ranked 13th or 14th out of all Market Makers in terms of trade volume -- and so was vulnerable.

¶15. (C) Martin, whose own status in Shanghai was unofficial since BMO's application to open a Shanghai branch continued to be refused, said that BMO had branches in Beijing and Guangzhou - with both of its branches holding RMB licenses. Martin said that BMO was not interested in pursuing RMB retail banking. Martin referred all forex questions to the head trader at BMO's Guangzhou branch, David Mu.

¶16. (C) Mu informed Econoff on October 26, via telecon and email, that intra and inter-day forex movements were based on four factors: (1) overnight customer positions, including those of the central bank; (2) speculative positions; (3) SAFE imposed position limits and the need to square any long position on the RMB before the end of the trading day; and, (4) SAFE's evaluation criteria for market makers. Mu noted that SAFE encouraged participation in all currency pairs by giving higher scores to banks who quote not just USD/RMB, but also JPY/RMB, EUR/RMB, GBP/RMB and HKD/RMB -- something that Mu said worked better for local banks. He also added that inter-day, overnight USD movement had significant influence on the next trading day's reference rate. He said that his regression analysis showed a higher correlation in EUR/USD than in USD/JPY on the RMB.

¶17. (C) Mu laughingly responded to Econoff's question about the increase in forex liquidity by stating that Econoff was after "state secrets which I don't know." That being said, Mu estimated that liquidity had increased this year by 10 to 20 fold.

¶18. (C) According to Mu, BMO's number one desire for institutional reform was the same as other Market Makers -- allowing banks to short the USD onshore. Mu said that not permitting the shorting of dollars in an attempt to control speculation on the RMB was completely ineffective. He pointed out that banks were already among the most regulated

institutions in the financial market and that not allowing them to short the USD actually increased their operating risk without providing tangible benefits for the central bank or other regulators.

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JP MORGAN: NOT A MARKET MAKER, BUT STILL A PLAYER
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¶19. (SBU) Providing the perspective of a non-Market Maker, but still very active CFETS currency trade, JP Morgan's Andrew Zhang said that there was a definite need to liberalize the one-directional nature of the market. Zhang said that an initial step might be to provide a "limited" ability to short the USD. JP Morgan had become a "Market Maker" in the forex swaps market due to its high level of swaps activity in order to meet its high demand for RMB, according to Zhang.

¶20. (C) Zhang said that to improve its forex system, the Chinese government needed to address the foreign debt limit that was based on a bank's onshore loans without taking into consideration that bank's other needs for forex. He agreed that traders needed to be able to hold net open positions both longing and shorting the dollar. He also said that he did not think that the Chinese had any desire to liberalize the interest rate system since it was one of their key mechanisms to control the economy. Zhang added that PBOC would also not want to widen the 0.3 percent trading band since "it would make clear how much it was manipulating the exchange rate."

¶21. (C) Zhang informed P/E Chief in a separate telecom on October 26 that JP Morgan was very interested in becoming a Market Maker on the OTC market. Its major obstacle to this was that JP Morgan did not meet the criteria set up by CFETS that

Market Makers must be among the top 50 cross-international border settlement of forex traders. When asked what advantages JP Morgan would have as a Market Maker that it currently did not have as a trader, Zhang said that as a Market Maker it would "be one step closer to the black box" where the Chinese government made its forex decisions.

¶22. (SBU) Zhang said that the CFETS forward market "died" in July 2006 when CFETS changed the rules that allowed it to both long and short the USD on the Forward Market. This rule, which according to Stephen Green, did not apply to Market Makers who were restricted from such trading, meant that JP Morgan could either long or short on a forward, but did not need to square the position until the contract matured. Since CFETS unified its rules for both Market Makers and non-Market Makers in July, all traders needed to include any forward contracts in determining their net open position when squaring at the end of the day. (Note: According to Stephen Green, Market Makers had never been allowed to benefit from this loophole, but non-Market Markets had been able to "game the system" until July. End note.)

Standard Chartered: PBOC still in Control

¶23. (C) Standard Chartered's (SC) Stephen Green said that China's economic growth continued to be strong despite the continued appreciation of the RMB. He noted that PBOC, which he said favored more movement towards a market-based exchange rate, made a point of talking about the textile market's continued strong international performance. However, Green said that the Ministry of Commerce was "still mostly conservative" on the issue of RMB appreciation and unconvinced that Chinese industry would not be hurt by a stronger yuan. Green said that clearly it was the PBOC moving the inter-day RMB rate, and the BOC, as PBOC's proxy that controlled the intra-day trading rates as well.

¶24. (SBU) Green listed several issues that SC had identified as important steps in the continued reform of China's forex market. These were: debt quota allocation reform, the ability to hold net open positions shorting the USD, and restructuring CFETS

fees.

¶25. (SBU) Green said that SC would like to see CFETS foreign debt quota system reallocated based on a bank's actual needs and not based on the previous year's figures. SC's 50 percent growth last year did not factor in the debt quota allocated this year. Green identified CFETS fee restructuring in terms of international norms as an important structural reform.

¶26. (C) The next change that CFETS must undertake, according to Green, was to allow banks to hold net open positions shorting the USD. He said that traders were "sort of allowed to short the dollar overnight" already, on an informal basis for "small amounts." He defined small amounts as $100-200 million and said that CFETS and SAFE "turned a blind eye" to these transactions because they seemed to understand that at the end of the trading day, a bank sometimes happens to end up short.

¶27. (C) Green also identified the lack of a real U curve as a central factor in limiting the market for interest rate products. According to Green, SC was one of three unnamed foreign banks part of the trial of the Shanghai Interbank Offered Rate (SHIBOR) that began on October 8. Green said that the Chinese government knew that it needed to liberalize interest rates, but was not sure "what should come first." He pointed out that there were seven loan rates and five deposit rates set by the PBOC, and that PBOC's next step was to reduce its involvement to just setting two rates.

¶28. (C) On November 17, Green informed P/E Chief that the measures implemented by SAFE in early November to limit offshore non deliverable forward (NDF) had produced the, perhaps

unintended, effect of increasing RMB appreciation. He said that after SAFE restricted both foreign and domestic banks operating in China from trading NDFs, there had not been enough buyers on Hong Kong NDF market -- leading to the RMB appreciation. Green also commented that another step taken by SAFE, after restricting NDF trades outside of China, was the liberalization of some of the documentation requirements. He said that Standard and Chartered foreign exchange traders felt that this was a step in the right direction, but not as much as was needed.

COMMENT:

¶29. (C) Having started the process of piece-meal reform of its currency market, China is faced with increasing demands from its forex traders -- interested in maximizing their own profits -- to continue the process. However, the more China liberalizes and reforms its forex market, the less it will be able to use politically-based macro-economic controls to limit inflation and to direct investment. For now, while China's technical and regulatory framework for a free-market based floating currency is in place, forex rates still appear to be directed based on political calculations.
JARRETT